

Julio Gomez testimony before the U.S. House of Representatives, Committee on Commerce, Subcommittee on Finance and Hazardous Materials

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On-line investing dynamics mirror the technology mantra of "faster, better, cheaper." To date, discount brokerage operations have dominated the development of this market.

Discount brokerage has for nearly 25 years focused on executing securities transactions for self-directed investors at reduced commission levels from full-service counterparts.

The evolution of Internet technology has provided fertile ground for the migration of these services to a still lower cost distribution platform. The dominant characteristics of the state of on-line investing are 1) consumers have enthusiastically received on-line investing offerings, 2) market growth has stimulated vigorous competition, 3) the lack of personalized financial advice is glaring, and 4) on-line investing services have been a tremendous benefit for retail investors.

Market Acceptance.

On-line investing services have found a hungry market. The mere availability of the product has been met with strong demand. Only in the past year have advertising budgets increased to multi-million dollar levels. Until the spring of 1997, "build it and they will come" was a truism. Evidence of market acceptance is characterized by the following:

- 1) The most popular product introduction in financial services history.** On-line investing services are without peer in terms of adoption rates. Neither CMA accounts nor Mutual Funds were able to generate 4.5 million customers in under 4 years.

- 2) **Growth in the market continues to surpass industry projections.** Estimates of projected volume and accounts in on-line brokerage have proven obsolete within months of being published. This will continue as reluctant, full-service firms move on-line in the coming years.
- 3) **Brokers taking on-line accounts are can't keep up with demand.** Rapid growth has also surprised the on-line brokers themselves. No firm has been able to invest in capacity fast enough to provide problem-free customer service. The events around October 27-28, 1997, forced many brokers to make hardware capacity and highly available customer service reps a top priority.

Fierce Competition.

The demand for on-line brokerage services means that market share is up for grabs. A mature market like financial services rarely sees a freeing up of this many potential customers. This condition attracts a lot of interest from opportunistic companies and entrepreneurs.

- 1) **Firms in Gomez Advisors' quarterly ranking have ballooned.** The Internet Broker Scorecard ranked 27 firms in June, 1997. As of April, 1998, there were more than 70 firms brokering on-line. The rate of growth in that period is actually higher for on-line brokers than for on-line investors.
- 2) **Price wars escalated quickly.** The impact of many new competitors is most felt in the pricing structure of the industry. There are now 7 brokers offering sub-\$10 commissions. Despite the industry's deepest desire to emphasize features other than price, nothing has been more successful in attracting new accounts quickly than low commissions.
- 3) **Marketing wars are heating up.** Brokers at the top of on-line advertising spending for non-technical products. Their spending levels and demand for "unique" ad placement have encouraged Web sites with valuable audiences to set up bidding wars for "exclusive" deals. Coming up with marketing messages and value propositions that rise above the noise is increasingly challenging for these firms.

Lack of Advice

Investors are flocking to on-line brokerage for the convenience and low priced commissions available for self-directed trading activity. They are also attracted to the wealth of market data and investment information available electronically and aggregated

on brokerage Web sites. What investors are not finding is personalized attention and assistance in making investment decisions. This is still only available off-line. Before on-line investors find personalized advice, three obstacles must be overcome:

- 1) **On-line financial planning is slow in coming.** The trend in retail brokerage is to work with clients to develop a long-term financial plan, and to base investment decisions on that plan. Large firms like Merrill Lynch and Smith Barney are encouraging this approach over sporadic calls from brokers offering investment "ideas" that stimulate a series of standalone transactions. The Internet is a superior medium for the collection of customer data and ongoing monitoring of a financial plan, but on-line financial planning products are still in development.
- 2) **Brokers are not analyzing the activity of their clients.** Firms have been so busy keeping up with demand, they have not had time to analyze data about how customers are using their site. Without this analysis, on-line brokers do not know enough about their customers to provide targeted investment direction. However, as firms begin to gather and mine data about their customer activity, they will be in a position to provide recommendations and direction that surpass the capabilities of any single registered representative left to his own devices.
- 3) **Advice-centric firms are afraid of the Internet.** Ironically, the firms that have the most to offer in the way of personalized advice are also the most reluctant to offer those services on-line. The primary reason is based on the registered representative's desire to control all aspects of communication with the customer. Relinquishing this control has proven unpalatable to reps, and managers at large brokerages are not anxious to alienate their distribution system.

Boon to Consumers

On-line investing services and the industry's competitive dynamics have been a windfall for the public. There has been a quantum leap in readily available market data, a drastic reduction in transaction costs, and a flood of interactive investing tools. The evolution of on-line investing has empowered the public vis-a-vis the securities markets as follows:

- 1) **Individuals have more information than many professionals.** A common lament among retail brokers today is "my customers see more than I do!" This is a good thing. Investors are taking more responsibility for monitoring their investments because the information is easier to obtain on the Internet.
- 2) **Customer costs are lower than many firms' clearing costs.** At less than \$20 a trade, retail investors are paying about the same amount that small broker/dealers pay to their transaction processors for a trade.

- 3) **The flurry of innovations, features, and benefits will continue.** In their effort to differentiate their on-line offerings, brokers are adding value in compelling ways. Market data and news is increasingly integrated with customer holdings, thus decreasing the effort required to monitor investments. Portfolio tracking software allows customers to analyze their holdings based on industry diversification and profitability. Stock screening tools assist investors in identifying good investments. Competitive pressures are pushing the industry to provide increasingly useful financial planning capabilities.